

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]:TL-N-3389-99
[REDACTED]

date:

to: [REDACTED], Group Manager
Coordinated Examination Branch, Group [REDACTED]
[REDACTED] Attn: [REDACTED]
Case Coordinator

from: Assistant District Counsel, Group [REDACTED]
[REDACTED] District

subject: [REDACTED]
Request for Legal Advice

THIS DOCUMENT INCLUDES STATEMENTS SUBJECT TO THE ATTORNEY CLIENT PRIVILEGE AND THE ATTORNEY WORK PRODUCT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYER INVOLVED. LIMIT USE OF THIS DOCUMENT TO THOSE WITHIN THE SERVICE WORKING ON THIS CASE. THIS DOCUMENT IS SUBJECT TO I.R.C. SECTION 6103.

This is in response to your request for legal advice regarding the following factual situation: [REDACTED] and [REDACTED] are [REDACTED] companies selling products through [REDACTED]. The [REDACTED] is carried by numerous [REDACTED] ([REDACTED]). In [REDACTED], one of the initial years of operation, [REDACTED] was a new concept and the number of [REDACTED] was limited. In order to persuade the [REDACTED] to carry their [REDACTED], [REDACTED] and [REDACTED] agreed to pay the [REDACTED] % of any sales generated to customers from their area. In addition, the [REDACTED] were granted the option (in the form of warrants) to purchase certain securities issued by [REDACTED] and [REDACTED]. [REDACTED] was subsequently acquired by [REDACTED] and is included with [REDACTED]'s consolidated return beginning with the fiscal year [REDACTED] tax return.

A total of approximately \$ [REDACTED] in warrants was issued by [REDACTED] in [REDACTED]. When [REDACTED] was acquired by [REDACTED] in [REDACTED], holders of the warrants were given the option of either cashing them in or receiving new warrants for [REDACTED] stock as replacements. Approximately \$ [REDACTED] of the \$ [REDACTED] in warrants were cashed. [REDACTED] amortized the difference between the fair market value on the date the warrants were cashed and the fair market

value on the date issued, over the remaining life of the affiliation agreements with the [REDACTED]. The District Director disallowed the amortization for several reasons including: (1) that the transactions did not qualify under Section 83 since there was no fair market value on the date the warrants were issued; and (2) the issuance of the warrants to the [REDACTED] was a start up cost for which no amortization was allowed.

The taxpayer appealed this determination to the Appeals Division. Appeals, after seeking technical advice from the National Office, settled the issue in favor of the taxpayer but did reduce some of the amounts amortized and did extend the time periods for amortization. As part of the settlement, the taxpayer and Appeals entered into a Closing Agreement (Form 906), which was executed on behalf of the Service on [REDACTED]. The Closing Agreement contains a schedule of the stocks and warrants to which it pertains. The Closing Agreement also contains the following language in paragraph 4:

[REDACTED]

As noted above, this issue involved only \$ [REDACTED] of approximately \$ [REDACTED] in warrants (the portion of the warrants that were cashed). The remaining \$ [REDACTED] in [REDACTED] warrants were exchanged for [REDACTED] replacement warrants which we believe had to be exercised by the end of [REDACTED]. The issue of the replacement warrants was never raised by the Examination Division in the prior cycle, even though it was specifically disclosed on [REDACTED]'s income tax return.

The issue of the amortization of the remaining \$ [REDACTED] in warrants has been raised in the present audit cycle. The taxpayer has claimed amortization expenses based upon the value of [REDACTED] stock from the issuance date in [REDACTED] (\$ [REDACTED] per share) and exercise date in [REDACTED] (\$ [REDACTED] per share). In the present audit cycle, this has resulted in a \$ [REDACTED] deduction for fiscal year ended [REDACTED] relating to the \$ [REDACTED] in warrants.

When asked by Revenue Agent Wayne Aiken to produce information regarding the warrants in the present cycle, the taxpayer replied that "the amount of the warrant amortization disclosed in the return for the year ended [REDACTED] is fixed pursuant to ... section 4 of the Closing Agreement." The warrants were issued by Taxpayer Number 2 in [REDACTED], a period covered by Section 4 of the Closing Agreement and reported by the taxpayer on a disclosure statement attached to its income tax return for the period ended [REDACTED]. You have asked us whether the closing agreement bars you from pursuing this issue.

It is our opinion that you are barred from pursuing this issue because of the language found in Section 4 of the Closing Agreement. This is a question of factual interpretation of the language of Section 4 of the Closing Agreement.

Section 4 provides that the Agreement resolves all issues " [REDACTED]

[REDACTED]."

Although the warrants at issue were not listed in the schedule, they were specifically reported by the taxpayer in the disclosure statement attached to its federal income tax return for [REDACTED] and said return was already filed as of the date that the Closing Agreement was executed.

We have spoken to Appeals Officer Joseph Bukis regarding this matter. Mr. Bukis advised us that the attorneys for the taxpayer spent a sizable amount of time drafting the language of Section 4. (b)(5)(DP)

[REDACTED]

Finality is a salient aspect of Closing Agreements. Because Closing Agreements are "final and conclusive", they are meant to preclude future litigation as to matters agreed upon. Clearly, the obvious interpretation of Section 4 of the Closing Agreement supports the taxpayer's position. We believe that any attempt by the Service to undermine this Closing Agreement would be very awkward. The effect of the Service claiming that a Closing Agreement that it entered was subject to an interpretation contrary to the clear language of the Agreement could have far reaching implications for past and prospective Closing Agreements.

A copy of this memorandum is being transmitted to our National Office for post review pursuant to our Manual Section (35)3(19)4. If our National Office makes any significant changes to our advice, we will notify you immediately.

Please feel free to contact Attorney [REDACTED] at [REDACTED] if you have any further questions regarding this matter.

[REDACTED]
Assistant District Counsel